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[Third Party Communication:
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Person To Contact: _____, ID No. _____

Telephone Number: _____

Refer Reply To:
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PLR-132641-10

Date:
January 5, 2011

Trust =
State =
Commission =
Fund =
Bill A =
Association =
Date 1 =
\$A =
\$B =
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Dear _____ :

This is in response to your August 6, 2010 letter requesting the following ruling:

Trust's income is excludable from gross income under I.R.C. § 115(1) because the Trust's income is derived from the exercise of an essential governmental function and accrues to a state or political subdivision thereof.

Facts and Representations:

Trust is represented as an agency of State that was created to allow local State governmental agencies to pool investment assets to pay for retiree health benefits. Trust was created after State's Governor formed Commission to deal with potential crisis that the present value of the liabilities for health benefits for retired public employees was \$A and only \$B had been set aside to pay retiree health benefits.

Commission's first recommendation was prefunding such benefits and as a policy this was as important as prefunding pensions.

It is represented that local agencies are establishing trusts to hold and invest assets for retiree health benefits. As these trusts accumulate assets, they are searching for economically efficient ways to invest these assets. In State, public agencies having most experience in investing assets for the benefit of public agencies and their employees are the large Funds. Using the Fund's expertise to invest Trust's assets makes sense, but only if Benefit assets are kept completely separate from Fund's assets.

State Bill A was enacted by State legislature and permitted the governing board of Association to establish Trust, a separate legal entity for the sole purpose of investing assets held by local agency trusts to provide retiree health benefits. State Bill A was carefully drafted to ensure that:

Trust was a separate local government agency, in particular separate from Association;

Trust's assets are held and owned separately from those of Association;

Only assets held by Trust are contributed to it by local agency trusts or local agencies for the exclusive purpose of providing retiree health benefits;

No assets received by Trust can revert to the public agency and must be used to provide retiree health benefits;

Trust will be responsible for investing contributed assets in accordance to fiduciary principles established in State Constitution and is not responsible for providing retiree health benefits.

The governing board of Association established Trust on Date 1. The Declaration of Trust says Trust's purpose is to establish a trust for public agencies to combine for investment assets set aside by local State government agencies for retiree health benefits, to take advantage of economies of scale and to use existing investment expertise to reduce the cost of providing retiree health benefits and to increase the security of such benefits. Trust assets are held exclusively to provide retiree health benefits to employees of public agencies and to defray the reasonable administrative costs of administering the Trust. If a local agency trust terminates participation in Trust, assets allocated to its account can only be transferred to another fund that holds the assets for the exclusive purpose of providing retiree health benefits. The exclusive purpose rule may not be amended to change or eliminate this requirement. Trust assets may not be alienated, attached or garnished.

State law provides which public agencies can participate in Trust. Trust's only source of assets are contributions and transfers of assets from a trust established by a local agency solely to provide for retiree health benefits or from a public agency on behalf of a local trust. The local agency, local agency trust and appropriate fiduciary are required to certify that the agency participating in Trust is a local government agency in adoption agreement. Only trusts established by entities whose income is excludable from gross income under Code section 115 may participate in Trust.

Each participating local agency trust and sponsoring local agency must sign an Adoption Agreement with Trust which sets out terms of participation and requires representations that all conditions are met including a representation of satisfying the requirements under section 115. Adoption Agreement states that there is no guaranty as to the federal tax treatment of payments or reimbursements made by the local agency trust, that Trust will seek a ruling relating only to Trust's income.

With respect to Trust investments being governed by State Constitutional Fiduciary Rules, a strict prudent person rule applies to Trust investments. It is represented that Trust assets, and Retirement Assets, may be parallel invested, not commingled, unless federal tax law allows comingling. Contributions of each participating local agency are accounted for separately.

Trust is governed by a D member board of trustees who are the same persons as Association's governing board. This is to take advantage of their existing expertise. State Government Code specifies the composition of the governing board. State's open meeting laws apply to Trust, like any other State public agency, and Trust makes regular reports of its operations to participating local agency trusts.

Only local agencies provide retiree health benefits, and the Trust only invests and disburses assets to local agency trusts and only for purpose of providing retiree health benefits. Local agencies must make written representations regarding the use of assets before disbursement. To the extent trust assets are used to pay fees, this comes either from contributions by local agencies or reduced net return to the local agency trust.

LAW & ANALYSIS

Section 115

Section 115(1) of the Code provides that gross income does not include income derived from any public utility or the exercise of any essential government function and accruing to a state or any political subdivision thereof.

In Rev. Rul. 77-261, 1977-2 C.B. 45, income from an investment fund, established under a written declaration of trust by a state, for the temporary investment of cash balances of the state and its participating political subdivisions, was excludable from

gross income for federal income tax purposes under § 115(1). The ruling indicated that the statutory exclusion was intended to extend not to the income of a state or municipality resulting from its own participation in activities, but rather to the income of a corporation or other entity engaged in the operation of a public utility or the performance of some governmental function that accrued to either a state or municipality. The ruling pointed out that it may be assumed that Congress did not desire in any way to restrict a state's participation in enterprises that might be useful in carrying out projects that are desirable from the standpoint of a state government and which are within the ambit of a sovereign to properly conduct. In addition, pursuant to § 6012(a)(2) and the underlying regulations, the investment fund, being classified as a corporation that is subject to taxation under subtitle A of the Code, was required to file a federal income tax return each year.

In Rev. Rul. 90-74, 1990-2 C.B. 34, the Service determined that the income of an organization formed, funded, and operated by political subdivisions to pool various risks (casualty, public liability, workers' compensation, and employees' health) was excludable from gross income under § 115 of the Code. In Rev. Rul. 90-74, private interests neither materially participated in the organization nor benefited more than incidentally from the organization.

Trust was created pursuant to State Law that was enacted after Commission made recommendations on funding of retiree health benefits for retired employees by local public agencies. Local public agencies that have set up trusts to prefund payment of retiree health benefits and in turn these trusts sign Adoption Agreements to participate in Trust to invest the local agencies trusts' assets, to benefit from economic efficiencies, as well as Trust's investment expertise to reduce the cost of funding retiree health benefits and increase the security of the retiree health benefits. Only local public agency trusts which satisfy the requirements of section 115 and which provide that proceeds from trust can be only used by the local trusts to pay health benefits to retired employees. Payment of such benefits constitutes the performance of essential government functions. Based upon Rev. Rul. 90-74 and Rev. Rul. 77-261, Trust performs an essential governmental function within the meaning of § 115(1) of the Code.

Trust income accrues to the local agency trusts. No private interests participate in or benefit from the operation of Trust. Any distribution of funds in Trust can only be used to pay retiree health benefits, whether a local trust withdraws from Trust or if Trust dissolves. The benefit to the participating employees is incidental to the public benefit. See Rev. Rul. 90-74.

Based on the information and representations submitted by Trust, we hold that the income of Trust is derived from the exercise of an essential governmental function and will accrue to a state or a political subdivision thereof for purposes of § 115(1).

Accordingly, Trust's income is excludable from gross income under § 115(1) of the Code.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

No opinion is expressed concerning the Federal tax consequences under any provision of the Code other than specifically cited above. In particular, no representation is made that contributions or premiums paid on behalf of or benefits received by employees, former employees, retirees, spouses, dependents or others will be tax-free. This ruling concerns only the Federal tax treatment of Trust's income and may not be cited or relied upon as to any matter relating to the taxation of accident or health contributions or benefits.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

Sylvia F. Hunt
Assistant Branch Chief, Exempt Organizations
Branch 2 (Exempt Organizations/Employment
Tax/Government Entities)
(Tax Exempt & Government Entities)